BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)

FINANCIAL COUNSELLORS, INC.)

Appearances:

For Appellant: Herbert Pothier
Attorney at Law

For Respondent: Lawrence C. Counts
Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Financial Counsellors, Inc., against proposed assessments of additional franchise tax in the amounts of $546.33, $499.85, $591.58, and $746.94 for the income years ended September 30, 1959, 1960, 1961, and 1962, respectively.

Financial Counsellors, Ind. (hereafter referred to as "appellant") was incorporated in California in 1945 for the purpose of engaging in the investment counselling business. This corporation, however, never did actively engage in that business.

Beginning in 1946 Mr. Morris Rabinowitch had engaged in the prorating business under the fictitious name Financial Counsellors, Section 12032.1 of the Financial Code defines a prorater as "a person who, for compensation from a debtor, engages in whole or in part in the business of receiving money or evidences thereof for the purpose of distributing the money or evidences thereof among creditors in payment or partial payment of past due obligations of the debtor."

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In 1949 appellant's stockholders objected to Rabinowitch's use of the name Financial Counsellors and they threatened to sue him. To avoid litigation Rabinowitch purchased all of appellant's stock and thereafter the corporation remained inactive until about January I., 1956.

The California Legislature enacted legislation in 1757 requiring that all proraters be licensed and that licenses be issued only to corporations organized for this purpose under the laws of California. (Fin, Code, §§ 12200, 12200.1.) In response to this legislative enactment, Rabinowitch caused Northern California Credit Counsellors, Inc. (hereafter referred to as Northern) to be created on December 3, 1957 for the purpose of carrying on the prorating business.

Appellant entered into agreements with Rabinowitch and Northern dated January 2, 1956 and October 1, 1957, respectively, whereby Rabinowitch and Northern were authorized to use the name Financial Counsellors in their business activities. No consideration was ever paid to appellants by Rabinowitch or Northern for use of the name. Appellant agreed to pay the operating expenses of Rabinowitch, subject to being reimbursed for such expenses. It was further agreed that Northern would reimburse appellant for all of the remaining expenses incurred by appellant.

During the years under appeal appellant functioned without pay as the operating company for the prorating business done by Financial Counsellors. Its employees serviced the old accounts obtained by Rabinowitch prior to September 11, 1957, as well as the new accounts acquired by Northern subsequent to that date. Appellant owned or leased thirteen offices in California which were used to conduct the prorating business. On July 25, 1961, appellant's articles of incorporation were amended to state that its principal purpose was to engage in the collection business.

Appellant's returns for each of the years in dispute indicated that its gross income consisted entirely of funds received from Rabinowitch and Northern and that all of these funds were used to pay the operating expenses of Financial Counsellors. Accordingly, appellant reported no taxable net income for any of the years in question. Northern's returns reflected nonscheduled deductions for funds transferred to Rabinowitch or appellant in reimbursement for expenses incurred in its behalf. As a result Northern reported net income of $1,120 for the income year ended October 31, 1959, and no net income for the years 1960, 1961, and 1962, respectively. All other net income from the prorating business was listed as earned by Rabinowitch.

Having determined that the books and records of the respective entities did not accurately reflect the true income earned by each, respondent allocated all of the income from the business activities to appellant under authority of Revenue and Taxation Code section 24725 which provides as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if it determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Section 24725 is virtually identical to section 482 of the Internal Revenue Code of 1954 which has received frequent construction by the federal courts. It has been held that the statute authorizes allocation of net income in lieu of allocating gross income and deductions. (Ballentine Co., 39 T.C. 348, aff'd, 321 F.2d 796.) In order to overturn the taxing agency's allocation of net income it must be shown that upon the particular facts the action taken was arbitrary, capricious and unreasonable. (Grenada Industries, Inc., 17 T.C. 231, aff'd, 202 F.2d 873, cert. denied, 346 U.S. 819 [98 L. Ed. 3453; Hamburgers York Road, Inc., 41 T.C. 821,)

Appellant contends that respondent's allocation of income was improper because it attributed to appellant income actually earned by Rabinowitsh. The main thrust of its argument is that appellant did not earn any income because it was not required to charge for the services it performed.

Our examination of the facts convinces us that respondent's determination was not arbitrary, capricious and unreasonable. The three entities were clearly controlled by the same interests. The judicially approved purpose of the allocation statute is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by providing for the determination of its income, according to the standard

of an uncontrolled taxpayer. (L. E. Shunk Latex Products, Inc., 18 T.C. 940.) An allocation is justified if necessary to reflect the true net income which would have resulted if one uncontrolled taxpayer had dealt at arm's length with another uncontrolled taxpayer. (Simon J. Murphy Co. v. Commissioner, 231 F.2d 639.)

We cannot envision any corporation carrying on business at arm's length which would have performed the services rendered by appellant without compensation. The conclusion is inescapable that the contractual agreements did not reflect arm's-length bargains according to the standards of uncontrolled taxpayers.

Further it is evident from the very record of this appeal that the distribution of net income as reflected by the books and records was fictitious. On cross examination appellant's accountant, Mr. Arnold F. Avritt, testified as follows:

> Q. Are you saying it was impossible to segregate expenses?
>
> Mr, Avritt. In my opinion it was impossible to separate the income accurately.
>
> Q. And so, not even making a guess, you didn't make any allocation whatsoever. You just assumed that all expenses were by one entity and not the others and allocated to one only and that is so reflected on your returns?
>
> Mr. Avritt. Well to answer your question truthfully, which of course I have to do, that is the way the income was reported on Mr. Rabinowitch's personal returns.

Having concededly made an improper allocation in its books and records appellant does not demonstrate that respondent acted arbitrarily, capriciously and unreasonably by merely contending that it was not required to charge for the services rendered.

From all that appears in the record the business activity of Financial Counsellors was essentially conducted by appellant. Its employees served as the connecting link, with the public and performed the services that actually earned the income. In view of this we approve of respondent's action. (Advance Machinery Exchange, Inc. v. Commissioner, 196 F.2d 1006, cert. denied, 344 U.S. 835 [97 L. Ed. 650].)

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Financial Counsellors, Inc., against proposed assessments of additional franchise tax in the amounts of $546.33, $499.85, $591.58, and $746.94 for the income years ended September '33, 1959, 1960, 1961, and 1962, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 12th day of December, 1967, by the State Board of Equalization.

Paul R. Leake, Chairman

_____, Member

_____, Member

_____, Member

_____ Member

ATTEST: _____ Acting Secretary